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SUBJECT: Argentina Economic and Financial Weekly for the week ending
September 1, 2006

Weekly Highlights

- GOA attempts to ease mortgage loan access.
- GOA uses "Superpowers" to reallocate fiscal surplus funds.
- Central Bank President Redrado calls high reserves best defense against intl. volatility.
- July construction activity index up 27.9 percent y-o-y... record high.
- GOA seeks to control prepaid medical plan rates.
- US Court of Appeals' ruling favorable to Argentina expected on the reserve freeze suit.
- Commentary of the Week: "The Real Solution for Mortgages is the Capital Market"

GOA attempts to ease mortgage loan access.

11. On August 17 the BCRA announced it will work to encourage banks to boost mortgage lending and ease applicant paperwork in an effort to address rising rents. This initiative follows Secretary of Internal Trade Guillermo Moreno's proposal to "reactivate" the mortgage loan market through an "incentives" plan. According to the National Bureau of Statistics (INDEC), rents jumped 7.2 percent year to date 2006, while the CPI increased 4.9 percent. Initially, only government-owned banks Banco de la Nacion Argentina, Banco Ciudad de Buenos Aires and five provincial banks (Buenos Aires, Santa Fe, Entre Rios, Santa Cruz and San Juan) announced they would expand their supply of mortgage credit. On August 30, the GOA announced that an additional 6 private banks (Macro Bansud, BBVA Frances, Rio, Galicia, Hipotecario and Credicoop) are also committed to this project. Media reports note that all these private banks were short on details, privately skeptical of the government's ability to grow the mortgage market absent direct subsidies (see Commentary article), and very concerned about their continuing inability to foreclose on 2002 crisis mortgage defaults: An emergency ban on foreclosures has been repeatedly extended by the Congress. The GOA also announced plans to encourage residential construction through strategies such as reimbursements on anticipated VAT (value added tax) reimbursements.

GOA uses "Superpowers" to reallocate fiscal surplus funds.

12. The GOA used recently approved so-called "superpowers" to reallocate ARP 750 million from its 2006 fiscal surplus to public works projects including road and sewer infrastructure and housing construction. Parliament recently granted the Chief of Cabinet power to reallocate budget funds irregardless of the provisions of the Financial Administration Act or the Fiscal Responsibility Law. Some estimates show that the reallocation will reduce the projected 2006 fiscal surplus by 4.8 percent.

Central Bank President Redrado calls high reserves best defense against international volatility.

13. On August 29, during an international economic symposium held by Tel Aviv University, BCRA president Martin Redrado said new economic configuration is here to stay, with highly volatile global imbalances, commodities prices, the rapid evolution of international commerce flows and increased geo-political uncertainty. According to Redrado, this new configuration augurs for increased volatility and high reserve stocks are the best strategy to smooth the impact of inevitable external shocks. Redrado also stated that the BCRA can comfortably continue its sterilization strategy, with discount borrowing incomes and from other sources remain above Lebacs and Nobacs interests payments.

July construction activity index up 27.9 percent y-o-y (seasonally adjusted) - a record high.

14. The National Bureau of Statistics (INDEC) released its July construction activity index, showing an increase of 27.9 percent y-o-y seasonally adjusted, the largest annual increase since March 2004. Construction activity, an important component of gross fixed investment, grew 3 percent m-o-m seasonally adjusted and 1.6 percent unadjusted. The fastest growing sectors were residential construction and private building for other purposes, up 26 percent and 27 percent y-o-y, respectively. During the first seven months of the year, construction activity rose 21.7 percent against the same period in 2005, taking the index to record highs.

GOA seeks to talk down prepaid medical plan rates.

15. On August 24, Secretary of Internal Trade Guillermo Moreno said that prepaid medical plan companies will not raise their rates as they had previously announced. Moreno added that companies which had already increased prices would have to reimburse their clients. A number of medical plan companies announced their intent to go ahead with planned increases. GOA Health Services Superintendent Hector Capaccioli urged Argentines (of whom some 2.5 millions engage private prepaid medical services) not to pay increasing rates in coming months and to file complaints with the Internal Trade Secretariat.

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16. According to local newspaper El Cronista, Chilean prepaid medicine provider Clio reported attempted extortion by the GOA Internal Trade Secretariat and suspended its five-year USD 20 million investment plan. According to this source, Clio General Manager Horace Galaz said the company would invest only what is necessary to maintain current services.

US Court of Appeals' ruling favorable to Argentina expected on reserve freeze suit.

17. On August 29, a US Court of Appeals held a hearing on USD 105 million in BCRA deposits frozen in the Federal Reserve of New York since late 2005. Plaintiffs EM Ltd and NML Capital seek to attach

the BCRA deposits, arguing that December 2005 GOA decrees authorizing the BCRA to use its reserves to repay IMF credits made these reserves ineligible for sovereign immunity. Argentine media anticipates a favorable U.S. court ruling for the GOA in light of amicus briefs in favor of Argentina's position filed by the USG.

Manager of second-largest fund group in Argentina keeping money out of the local stock market.

¶8. Banco Santander Central Hispano's executive Ricardo Daud, manager of the second-largest fund group in Argentina, said he has limited Argentine equity holdings to only 3.5 percent of his Latin America fund, with fully 57 percent invested in Brazilian and 29 percent in Mexican assets. According to Daud, GOA policies are squeezing corporate profits, adding that "even with the Argentine economy growing at high rates, from the point of view of quality it is not going as well as in other regions." Daud oversees ARP 2 billion in various funds at the Buenos Aires unit of this Madrid-based bank

Former Minister Lavagna warns on impact of a power crisis on companies' costs of production.

¶9. Former Kirchner's Economic Minister Roberto Lavagna warned about the impact of a future power crisis on companies' costs of production. According to Lavagna, a power crisis in Argentina is not a potential risk, but a current and very serious problem. With private companies already building their own back-up power plants in anticipation of future grid shortages, Lavagna projected production costs will rise, putting pressure on prices.

Tax revenue expected to increase 22 percent y-o-y to ARP 12.5 billion in August.

¶10. According to Reuters, a source at the Ministry of Economy said August federal tax revenues jumped 22 percent to ARP 12.5 billion. This estimate is in line with BCRA consensus survey projections. The BCRA forecasts tax revenues of ARP 144.2 billion for 2006.

Beef producers try to reopen the beef export market.

¶11. On August 30, the GOA extended the mechanism to ease the beef export ban for an additional 30-day period. Manufacturers and producers are working to persuade Economic Minister Felisa Miceli that the sector will supply the local market at the agreed prices even if the beef export ban is fully terminated. According to the National Food and Animal Health Inspection Service (SENASA), Argentine beef exports totaled USD 480 million during first half of 2006, down from USD 627 million in the same period in 2005 (-23 percent y-o-y). By volume, beef sales decreased 37 percent y-o-y. [On March 8, 2006, the GOA imposed a ban beef exports for 180 days and raised export taxes on boned cuts and heat-processed beef from 5 percent to 15 percent in an attempt to keep local prices under control. On May 29, the GOA eased the ban via an export quota system.]

GOA analyzes pension system reform for 2007 budget.

¶12. According to local media, the GOA is working on a pension system reform to capitalize the pay-as-you-go public retirement system, easing the impact of pension adjustments to be included in the 2007 budget. One option is to allow those starting their first jobs to join and contribute to the public retirement program, if they have not yet contributed to private pension funds (AFJPs). Such up-front new hire payments into to the public system could ease the fiscal burden of anticipated pension payment increases in the 2007 budget. [Currently new hires who don't specifically ask to be

included in the public pension system are automatically incorporated into the private AFJP system.]

GOA announces oil exploration incentives for private companies.

¶13. The GOA will offer private oil companies the chance to become "partners" with GOA-owned energy company Enarsa, supplying financing for hydrocarbon exploration. Budget-constrained Enarsa owns all exploration permits and production concessions for offshore areas that were not under license when it was created by law (November 2, 2004). According to a Ministry of Economy resolution dated July 31 of 2006, Enarsa has a staff of 24 employees and a limited exploration budget of ARP 2.9 million.

GOA reduces export tariffs on some dairy products.

¶14. On August 24, the GOA announced it will reduce export tariffs on powder milk from 15 percent to 10 percent, and on cheese products from 10 percent to 5 percent. These taxes were raised July 2005 in an effort to contain rising domestic dairy product prices. Analysts attribute this easing to an expected 10 percent-30 percent increase in milk production.

GOA reduces import tariffs on Brazilian cars.

¶15. On August 24, the Economy Ministry announced a significant reduction in Brazilian car import tariffs from 70 percent to 35 percent, dropping back to a rate earlier imposed until 2005. This measure comes as a result of a reduction in Argentina's trade deficit with Brazil.

Tourism up 33 percent y-o-y in Q2 of 2006.

¶16. The National Bureau of Statistics (INDEC) announced that net tourism revenues increased 33 percent y-o-y in the second quarter of 2006, with the number of incoming tourists up 20 percent y-o-y to 445,000 partially offset by the number of outgoing tourists up 12 percent y-o-y to 271,000. Preferred tourist destinations include the city of Buenos Aires, Cordoba Province, and the Atlantic coast, chosen by 55 percent, 6 percent and 4 percent of tourists, respectively. Visiting tourists were mainly from the European Union (22 percent), followed by Brazil (19 percent), the rest of Latin America (16 percent), and the U.S. and Canada (15 percent).

GOA promises Japan to deal with holdouts investors "in the future".

¶17. On August 29, Argentine Foreign Minister Jorge Taiana and Japanese Senate president Chikage Oogi met in an attempt to reestablish "normal" bilateral relations following the GOA default on sovereign debt obligations in December 2001. They discussed Japanese holdout investors (those who chose not to participate in the GOA debt exchange that closed February 2005), who retain approximately USD 2.5 billion in defaulted GoA sovereign debt. According to local media, the GOA promised Japan it would reopen the debt exchange "in the future", but under conditions less favorable than those granted to investors who accepted the debt exchange. A similar promise was made to Italian public officials during their visit last June (Italian holdouts retain approximately USD 5 billion in defaulted GOA sovereign debt).

Bolivian strike cuts gas delivery to Argentina for a day.

¶18. On August 28, Bolivian protesters closed the valves of a gas pipeline linking Bolivia and Argentina during a strike against Argentina's new policy limiting the times Argentines can cross the border to Bolivia to once per month and capping purchases they can

carry back at USD 50 per trip. According to the strike's leaders, future gas delivery disruptions are not out of the questions while they wait for Bolivia's President Evo Morales to offer a solution. The shutdown prevented the delivery of some 4.9 million cubic meters of gas.

Sel Consultores publishes alarming social indicators about the urban young.

¶19. SEL Consultores published a study showing 14 percent of Argentine youth aged 20-24 (740,000) in the most populated urban areas are neither working, trying to find a job nor studying. Some 10 percent of the youth aged 20-24 are extremely poor and an additional 22 percent are poor. For those trying to find a job, the unemployment rate reaches 24 percent, and this rate grows to 33 percent for those aged 15-19. For those working aged 20-24, 58 percent have informal jobs, and 36 percent have informal jobs that are highly unstable. These urban youth social indicators contrast with the promising reduction in unemployment announced by INDEC recently, down to 10.4 percent in the second quarter of 2006 from 12.1 percent in the second quarter of 2005.

BCRA rolls over maturities and rejected 82 percent of all Nobac bids.

¶20. The BCRA received ARP 1.2 billion in bids at its August 29 Lebac and Nobac auction. No Lebacs or Nobacs came due during the week. It accepted ARP 634 million in Lebac bids and ARP 72 million in Nobac bids. The yield on the 182-day Lebac was 8.50 percent and the yields on the 231-day Lebac and 343-day Lebac decreased from 9.90 percent to 9.85 percent and from 11.65 percent to 11.55 percent, respectively. The yield on the longest term instrument, the 623-day Lebac, was 12.25 percent. The 518-day Lebac was withdrawn because of the BCRA's decision not to validate the yield proposed by the market. The spread on the one-year Nobac decreased from 1.15 percent to 1.10 percent and the two-year Nobac increased from 2.68 percent to 2.73 percent. The Badlar rate (the base rate for Nobacs) is currently at 9.4 percent. Rates fell (except on the

two-year Nobac) for the fifth consecutive week due to strong market demand and the BCRA's decision to accept more Lebacs rather than Nobacs bids (rejecting 82 percent of all Nobac bids).

Peso depreciates against the USD, closing at 3.11 ARP/USD.

¶21. The peso depreciated slightly versus the USD August 28 and remained at 3.11 ARP/USD for the rest of the week. The peso exchange rate has depreciated 1.97 percent since the beginning of the calendar year. BCRA's reserves stood at USD 27.2 billion as of August 29, and have increased USD 8.7 billion, or 47 percent, since the GOA prepaid its entire IMF debt on January 2.

Commentary of the week: "The Real Solution for Mortgages is the Capital Market", by Miguel Kiguel, from an article published in El Cronista Comercial on August 30.

¶22. These days, there is great interest in finding new solutions to grow the mortgage market in order to facilitate access to financing for prospective home owners. There are two key impediments restricting access to mortgage credit.

¶23. The first is a colossal gap between property prices and salaries. Most workers cannot cover a mortgage payment with 30 percent of their salary. On average, property prices have gone up 25 percent in dollars since the devaluation in 2002, while the equivalent dollar value of salaries has dropped about 30 percent in the same period.

¶24. The second problem is that, for the mortgage market to become an important source of home financing, capital markets - and in

particular institutional investors including pension funds and insurance companies must play a larger role. Banks, in general, can only finance a limited volume of long-term fixed rate mortgages given their liabilities are mostly short-term variable rate deposits.

¶25. In most countries, banks originate mortgages taking advantage of their distribution capacity, with the bulk sold down to the secondary market. These portfolio sales are done at market interest rates; therefore a ten-year mortgage would have a slightly higher rate than a ten-year Treasury bond rate.

¶26. In Argentina it is difficult to determine what the rate would be today, since there are no long-term fixed rate instruments. The closest we can get is through the one-year LEBAC issued by the Central Bank which has a 12 percent return. The rate for a ten-year investment would surely be higher, at least 14 percent. This, then, would be the base rate at which banks could sell mortgages in the secondary market.

¶27. What are the alternatives? One is that the banks lend money at lower rates but maintain their mortgage portfolios on their own balance sheets. The main constraint of this option is that it sets a ceiling for growth for the mortgage market. Another option is to try to lower the interest rate. In some countries, like Spain, this objective has been achieved by using adjustable interest rates, for example linking it to the CD rate. Banks prefer this mechanism because they are protected in case of a rise in interest rates.

¶28. With lower interest rates, there would be a larger number of families who could qualify for mortgages, broadening the market. The main obstacle for variable interest rates that Argentina faces today is debtors' fears of a possible hike in rates, understandable given a history of macroeconomic instability and a sustained two-digit inflation rate.

¶29. What economic policy measures can be taken in order to remove this credit holdup? The Central Bank has already made some changes in regulations allowing banks to finance a larger share of residential home credits by allowing banks more flexibility in calculating minimum income requirements for mortgage applicants.

¶30. However, rather than in issuing more banking regulations, what is most needed are measures to facilitate the development of capital markets. Among these measures could be the creation of an interest rate swap mechanism allowing debtors to take fixed-rate credits and banks to lend to a variable rate. While this market will eventually grow on its own, initially it will require Government support.

¶31. A second measure is the creation of a fund to subsidize monthly mortgage payments during the first five years so debtors could qualify for credit. This subsidy should be paid back in full by the debtor during the out years of a mortgage. The pay-back would be possible since income is expected to grow at the same rate of inflation. This mechanism should not have a net fiscal cost.

¶32. Summarizing, the development of an Argentine mortgage market depends on the ability to develop capital markets. The economic policy measures outlined above offer solutions compatible with the development. (Note: We reproduce selected articles by local experts for the benefit of our readers. The opinions expressed are those of the authors, not of the Embassy. End Note.)

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